

REPORT BY THE
AUDITOR GENERAL
OF CALIFORNIA

**FINANCIAL AUDIT REPORT
CALIFORNIA STUDENT AID COMMISSION
CALIFORNIA EDUCATIONAL LOAN PROGRAMS
YEAR ENDED JUNE 30, 1983**

REPORT BY THE
OFFICE OF THE AUDITOR GENERAL
TO THE
JOINT LEGISLATIVE AUDIT COMMITTEE

F-338

FINANCIAL AUDIT REPORT
CALIFORNIA STUDENT AID COMMISSION
CALIFORNIA EDUCATIONAL LOAN PROGRAMS
YEAR ENDED JUNE 30, 1983

APRIL 1984



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April 11, 1984

F-338

Honorable Art Agnos, Chairman
Members, Joint Legislative
Audit Committee
State Capitol, Room 3151
Sacramento, California 95814

Dear Mr. Chairman and Members:

The Office of the Auditor General presents its financial audit report for the California Student Aid Commission's California Educational Loan Programs for the year ended June 30, 1983. We prepared the report to meet the commission's obligation to provide audited financial statements of the loan program to lenders participating in the program.

Respectfully submitted,


THOMAS W. HAYES
Auditor General

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AUDITOR'S OPINION

We have examined the balance sheets of the California Student Aid Commission's California Educational Loan Programs as of June 30, 1982 and 1983, and the related statements of revenues, expenditures, and changes in fund balance for the years then ended. We made our examinations in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the financial statements referred to above present fairly the financial position of the California Student Aid Commission's California Educational Loan Programs at June 30, 1982 and 1983, and the results of their operations and changes in fund balance for the years then ended, in conformity with generally accepted accounting principles applied on a consistent basis.

OFFICE OF THE AUDITOR GENERAL

A handwritten signature in cursive script, appearing to read "Karl W. Dolk".

KARL W. DOLK, CPA
Assistant Auditor General

January 26, 1984

Staff: Ulrich Pelz, CPA, Audit Manager
Jeffrey A. Winston, CPA
Wanda Fong

INTRODUCTION

We have conducted a financial audit of the California Student Aid Commission's California Educational Loan Programs. The California Student Aid Commission (commission) requested this audit to meet its obligation to provide audited financial statements to lenders participating in the California Educational Loan Programs.

The California Educational Loan Programs include the State Guaranteed Student Loan Program and the California Loans to Assist Students Program. Chapter 1201, Statutes of 1977, established the State Guaranteed Student Loan Program and authorized the commission to serve as a guarantee agency for student loans. This program carries out the provisions of the Federal Guaranteed Student Loan Program instituted within the Federal Higher Education Act of 1965, as amended (P.L. 94-482). Also by authority of Chapter 1201, Statutes of 1977, the commission in 1982 established the California Loans to Assist Students Program. The commission is responsible for guaranteeing federally reinsured loans issued to students and parents for postsecondary education expenses.

The commission has contracted with the E. D. S. Corporation, a subsidiary of Electronic Data Systems Corporation, to provide administrative support services from January 3, 1983, to February 28, 1986. These services include processing and approving all student loan applications, collecting insurance premiums, maintaining and managing the

loan portfolio, processing claims from lenders, pursuing collections, and preparing reports required by the United States Department of Education. United Student Aid Funds, Inc., had provided these services through December 1982.

The California Educational Loan Programs are supported by federal funds, investment earnings, and insurance premiums paid by student borrowers.

We conducted the present audit under the authority vested in the Auditor General by Section 10500 et seq. of the Government Code.

**CALIFORNIA STUDENT AID COMMISSION
CALIFORNIA EDUCATIONAL LOAN PROGRAMS
BALANCE SHEET AS OF JUNE 30, 1982 and 1983**

	<u>1982</u>	<u>1983</u>
<u>Assets</u>		
Cash	\$ 44,249	\$ 87,537
Insurance premiums receivable (Note 3)	344,793	6,615,386
Due from other funds (Note 4)	29,209,308	42,642,539
Due from federal government (Note 5)	5,687,317	24,132,328
Equipment	<u>83,348</u>	<u>87,088</u>
Total Assets	<u>\$35,369,015</u>	<u>\$73,564,878</u>
 <u>Liabilities and Fund Equity</u>		
<u>Liabilities</u>		
Due to General Fund (Note 6)	\$ 1,271,276	\$22,297,151
Due to federal government	<u>0</u>	<u>54,031</u>
Total Liabilities	<u>1,271,276</u>	<u>22,351,182</u>
 <u>Fund Equity</u>		
Investment in fixed assets	<u>83,348</u>	<u>87,088</u>
Fund Balance		
Reserved for loan defaults (Note 7)	22,771,788	32,922,831
Designated for federal advance (Note 8)	2,144,764	4,964,758
Undesignated	<u>9,097,839</u>	<u>13,239,019</u>
Total Fund Balance	<u>34,014,391</u>	<u>51,126,608</u>
Total Fund Equity	<u>34,097,739</u>	<u>51,213,696</u>
Total Liabilities and Fund Equity	<u>\$35,369,015</u>	<u>\$73,564,878</u>

See the notes accompanying the financial statements.

**CALIFORNIA STUDENT AID COMMISSION
CALIFORNIA EDUCATIONAL LOAN PROGRAMS
STATEMENT OF REVENUES, EXPENDITURES,
AND CHANGES IN FUND BALANCE
FOR FISCAL YEARS ENDED JUNE 30, 1982 AND 1983**

	<u>1982</u>	<u>1983</u>
Revenues		
Insurance premiums (Note 11)	\$16,063,559	\$12,536,806
Intergovernmental revenue (Note 12)	5,687,317	4,924,854
Interest	2,531,342	3,703,493
Miscellaneous income	<u>6,044</u>	<u>39,906</u>
Total Revenues	<u>24,288,262</u>	<u>21,205,059</u>
Expenditures		
Personal services	690,341	989,303
Operating expenses and equipment	310,659	672,570
Contract fees (Note 13)	<u>4,654,572</u>	<u>5,300,056</u>
Total Expenditures	<u>5,655,572</u>	<u>6,961,929</u>
Excess of Revenues over Expenditures	18,632,690	14,243,130
Other Financing Sources:		
Federal advance (Note 8)	<u>50,000</u>	<u>2,869,087</u>
Excess of Revenues and Other Sources over Expenditures	18,682,690	17,112,217
Beginning fund balance, July 1	<u>15,331,701</u>	<u>34,014,391</u>
Ending fund balance, June 30	<u>\$34,014,391</u>	<u>\$51,126,608</u>

See the notes accompanying the financial statements.

NOTES TO THE FINANCIAL STATEMENTS

1. DEFINITION OF REPORTING ENTITY

The California Educational Loan Programs include the State Guaranteed Student Loan Program and the California Loans to Assist Students Program. In the previous financial report for the year ended June 30, 1982, the financial statements reflected the financial position and results of operations of the State Guaranteed Student Loan Program only. The California Loans to Assist Students Program began in fiscal year 1982-83 and contributed approximately \$27,000 to revenues and \$1,460 to expenditures.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The accompanying financial statements reflect the financial position and results of operations of the California Educational Loan Programs of the California Student Aid Commission (commission). The financial statements have been prepared in conformity with generally accepted accounting principles applicable to state and local governments. Below is a summary of the more significant accounting policies.

Fund Accounting

The California Educational Loan Programs are accounted for separately as a part of the State Guaranteed Loan Reserve Fund. The State Guaranteed Loan Reserve Fund was created to account for all monies received for guaranteeing loans to students and parents for postsecondary education expenses and to account for reimbursements to lending institutions for defaulted student loans. This fund is accounted for as an Expendable Trust Fund. Expendable Trust Funds account for assets held in a trustee capacity, and both principal and income may be expended in the course of the fund's designated operations.

Basis of Accounting

Expendable Trust Funds are accounted for on a modified accrual basis of accounting. Revenues are recognized in the accounting period in which they become measurable and available. Expenditures are recognized, if measurable, in the accounting period in which the liability is incurred, except that the costs of vacation and sick leave are charged when these benefits are used rather than when they are earned.

3. INSURANCE PREMIUMS RECEIVABLE

The amount in this account increased because of a change in the procedure for remitting insurance premiums to the commission. The amount at June 30, 1982, represents insurance premiums collected by United Student Aid Funds, Inc., during June 1982. The amount at June 30, 1983, represents insurance premiums collected from January through June 1983, by E. D. S. Corporation, the commission's new service contractor. The commission permitted the new service contractor to use the premium collections as a temporary funding mechanism to pay lenders for defaulted loans until the contractor was reimbursed.

4. DUE FROM OTHER FUNDS

This account includes amounts due from the Surplus Money Investment Fund (SMIF) for temporary cash investments and interest earned on the investments in marketable securities. It also includes amounts due from the General Fund for insurance premiums collected by the General Fund but not remitted to the State Guaranteed Loan Reserve Fund as of June 30. The following schedule summarizes the account balances as of June 30, 1982 and 1983:

<u>Fund</u>	<u>1982</u>	<u>1983</u>
SMIF Investment	\$27,207,000	\$40,727,000
SMIF Interest	<u>1,538,535</u>	<u>1,915,539</u>
Total SMIF	28,745,535	42,642,539
General Fund	<u>463,773</u>	<u>0</u>
Total	<u>\$29,209,308</u>	<u>\$42,642,539</u>

5. DUE FROM FEDERAL GOVERNMENT

This account represents the June 30, 1982 and 1983, balances due from the United States Secretary of Education for amounts billed as reimbursement of administrative costs. The amounts apply to administrative costs that the commission incurred during the respective fiscal years and that are due in the subsequent fiscal years. Under present procedures, the commission bills the United States Secretary of Education for reimbursement of either one percent of the balance of loans guaranteed or the actual administrative costs, whichever is less. The United States Secretary of Education pays the invoice depending upon the availability of federal funds.

For June 30, 1983, this account also includes balances due from the United States Secretary of Education for amounts billed for defaulted loans that the commission purchased under a federal reinsurance agreement. (See also Note 14.)

The following schedule summarizes the amounts due from the federal government as of June 30, 1982 and 1983:

	<u>1982</u>	<u>1983</u>
Administrative Costs	\$5,687,317	\$ 4,132,359
Defaulted loans purchased	<u>0</u>	<u>19,999,969</u>
Total	<u>\$5,687,317</u>	<u>\$24,132,328</u>

6. DUE TO GENERAL FUND

This account represents the operating costs incurred by the General Fund on behalf of the State Guaranteed Loan Reserve Fund during June 1982 and 1983, respectively. In addition, this account includes the loans in default that the General Fund purchased from lenders on behalf of the State Guaranteed Loan Reserve Fund during June 1983.

7. RESERVED FOR LOAN DEFAULTS

The commission must maintain a reserve for the repurchase of defaulted loans. The commission must initially deposit to this reserve at least 80 percent of the insurance premium revenue and the interest earnings from federal advances received under Section 422 (c) of the Higher Education Act of 1965. Funds in this reserve can be used only for the purchase of defaulted loans. The cumulative insurance premiums collected and interest earned were \$28,464,735 and \$41,123,139 as of June 30, 1982 and 1983, respectively.

8. DESIGNATED FOR FEDERAL ADVANCE

The commission has received advances from the United States Secretary of Education totaling \$5,478,163. Before 1967, the United States Secretary of Education advanced \$1,479,865 to the commission for the Guaranteed Loan Program, which existed at the time. Since 1977, the commission has also received advances totaling \$3,998,298 for the California Educational Loan Programs. These advances were made under an agreement between the United States Secretary of Education and the commission. This agreement allows the Secretary to call upon the commission to repay part or all of any sums advanced to the commission.

The two loan programs are accounted for in the State Guaranteed Loan Reserve Fund, but they are separated for reporting purposes. As of June 30, 1983, the amount available in the Guaranteed Loan Program to repay advances was \$513,405. Consequently, the remaining advance balance of \$4,964,758 could be payable from the California Educational Loan Programs.

During the fiscal years ended June 30, 1982 and 1983, the commission received federal advances of \$50,000 and \$2,869,087, respectively. These amounts are shown under "Other Financing Sources" on the Statement of Revenues, Expenditures, and Changes in Fund Balance. In the previous financial report for the year ended June 30, 1982, the amount of federal advances was included in intergovernmental revenue.

9. LENDERS' AGREEMENTS

The commission's agreements with lending institutions require that it maintain a Guarantee Reserve Fund. This fund must be represented by cash and marketable securities, and it must have a total market value of not less than one percent of the total amount of unpaid principal and interest of all approved notes that are covered by federal reinsurance under the agreement between the commission and the United States Secretary of Education. At June 30, 1982 and 1983, the commission's cash and marketable securities exceeded the amounts required by approximately \$16.8 million and \$24.3 million, respectively.

In January 1983, the commission also entered into a "Guarantee Reserve Agreement" with the California Student Loan Authority, which was established to provide a secondary market for loans to students and parents. This agreement requires that the commission maintain a fund balance reserved for loan defaults in the California Educational Loan Programs. This fund balance must be equal to at least one percent of the unpaid principal amount of all loans guaranteed by the commission. At June 30, 1983, the commission's fund balance reserved for loan defaults exceeded the amount required by approximately \$14.5 million.

10. RETIREMENT COMMITMENTS

Regular employees of the commission are members of the Public Employees' Retirement System (PERS), which is a defined benefit, contributory retirement plan. The amount that the commission and its employees contribute to the PERS is determined actuarially under a program in which contributions plus retirement system earnings provide the necessary funds to pay retirement costs as they are accrued. The California Educational Loan Program's share of retirement contributions were \$78,765 and \$79,426, respectively, for fiscal years ended June 30, 1982 and 1983.

11. INSURANCE PREMIUMS

Student borrowers pay insurance premiums when the lending institutions make loan disbursements. The commission may use these premiums to underwrite defaulted loans and to cover costs that the commission incurs in administering the loan program.

12. INTERGOVERNMENTAL REVENUE

This amount represents federally reimbursed administrative costs.

13. CONTRACT FEES

This amount represents payments for administrative support services. The payments were made to United Student Aid Funds, Inc., through December 1982, and to E. D. S. Corporation beginning in January 1983. Under the contract with United Student Aid Funds, Inc., the fees were calculated as a percentage of the total amount of loans outstanding at the end of each month. Under the contract with E. D. S. Corporation, the fees are calculated at various percentages, depending on whether the loan amount is classified as guaranteed during the month, as outstanding at the end of the month, or as a claim purchased during the month.

14. FEDERAL REINSURANCE AGREEMENT

The agreements between the California Student Aid Commission and the lenders participating in the loan program require that the commission purchase guaranteed loans that have been defaulted if the lender has exercised due diligence in making, servicing, and collecting the loan. Likewise, the agreement between the commission and the United States Secretary of Education requires the Secretary of Education to repurchase a percentage of those defaulted loans that the commission purchases. Through federal fiscal year ended September 30, 1983, the United States Secretary of Education purchased 100 percent of the amount of defaulted loans. However, beginning with the 1983-84 federal fiscal year, the percentage of defaulted loans that the United States Secretary of Education purchases may vary. The federal government will repurchase 100 percent of the amount of loans until the default purchases reach 5 percent of the amount of loans in repayment at the end of the preceding federal fiscal year. When the default purchases reach 5 percent of the amount of loans in repayment, the federal government will repurchase 90 percent of the defaulted loan amounts. When the default purchases reach 9 percent of the amount of loans in repayment, the federal government will repurchase 80 percent of the defaulted loan amounts.

15. SUBSEQUENT EVENTS

As described in Note 14, the federal government will repurchase only 90 percent of the amount of defaulted loans when the rate defined in Note 14 reaches 5 percent, and only 80 percent when the rate reaches 9 percent. The amount of loans in repayment at September 30, 1983, was approximately \$630 million. As of January 26, 1984, the amount of default purchases as a percentage of loans in repayment at September 30, 1983, had reached 3.8 percent. The federal government was still obligated to repurchase 100 percent of the amount of defaulted loans at that time.

OTHER COMMENTS

As an integral part of our examination, we reviewed the accounting procedures of the California Student Aid Commission and its related system of internal accounting control to the extent we considered necessary to form an opinion on the fairness with which the financial statements of the California Educational Loan Programs present the programs' financial position and the results of their operations in accordance with generally accepted accounting principles consistently applied. As part of our review, we are issuing a management letter to the commission suggesting action that it should take to improve its administration of the California Educational Loan Programs. Our letter will also recommend adjusting entries necessary to achieve compliance with generally accepted accounting principles. The commission is taking action to improve its administration of the loan programs, and it concurs with the adjusting entries.

cc: Members of the Legislature
Office of the Governor
Office of the Lieutenant Governor
State Controller
Legislative Analyst
Director of Finance
Assembly Office of Research
Senate Office of Research
Assembly Majority/Minority Consultants
Senate Majority/Minority Consultants
Capitol Press Corps